

Oversight Report



QUALITY CONTROL REVIEW OF ERNST & YOUNG LLP
AND THE DEFENSE CONTRACT AUDIT AGENCY
SOUTHWEST RESEARCH INSTITUTE
FISCAL YEAR ENDED SEPTEMBER 27, 1996

Report Number PO 98-6-017

September 11, 1998

Office of the Inspector General
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Acronyms

DCAA	Defense Contract Audit Agency
E&Y	Ernst & Young
GAGAS	Generally Accepted Government Auditing Standards
OMB	Office of Management and Budget
SwRI	Southwest Research Institute



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September 11, 1998

Southwest Research Institute
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SUBJECT: Quality Control Review of Ernst & Young LLP
and the Defense Contract Audit Agency
Southwest Research Institute
Fiscal Year Ended September 27, 1996
Report No. PO98-6-017 (Project No. 8OA-9008.09)

Introduction

We are providing this report for your information and response. The San Antonio, Texas, office of Ernst & Young LLP (E&Y), and the San Antonio, Texas, office of the Defense Contract Audit Agency (DCAA), performed the single audit for the Southwest Research Institute (SwRI), for the fiscal year ended September 27, 1996. The audit was required by Office of Management and Budget (OMB) Circular A-133, "Audits of Institutions of Higher Education and Other Nonprofit Institutions." For the fiscal year ended September 27, 1996, SwRI reported total Federal expenditures of \$89,358,874, representing \$27,522,389 for the Department of Defense and \$61,836,485 for other Federal agencies.

The E&Y audit report, dated November 4, 1996, includes an unqualified opinion on the SwRI financial statements. On September 24, 1997, DCAA issued audit reports on compliance with general requirements, on internal controls related to OMB Circular A-133, and on incurred costs.

Although only statements of positive and negative assurance were required, DCAA issued an opinion on compliance with general requirements. The opinion was qualified with respect to the general requirement for allowable costs/cost principles. The DCAA took exception to \$147,780 of leasing costs for excess equipment in a proposed overhead expense pool (see Enclosure 1). SwRI concurred with DCAA.

The DCAA auditors obtained an understanding of the internal controls related to Federal research and development awards. The audit report describes the auditors' scope of work in obtaining that understanding and in assessing control risk. The DCAA report on internal controls further describes the significant internal controls and control structure. The report includes statements on reportable conditions, material weaknesses, and controls that provide reasonable assurance that Federal awards are being managed in accordance with applicable laws and regulations.

Quality Control Review Results

Except for the immaterial finding addressed below, the audit report submitted by SwRI, prepared by DCAA, meets the requirements of OMB Circular A-133 and the General Accounting Office *Government Auditing Standards*, June 1994.

The audit report submitted by SwRI, prepared by E&Y, does not meet the requirements of OMB Circular A-133 and the General Accounting Office *Government Auditing Standards*, June 1994. This issue is addressed in the Material Finding section.

Immaterial Finding: Inadequate Reporting on Specific Requirements

The DCAA "Report on Audit of Incurred Costs for SwRI," September 24, 1997, does not refer to the specific requirements of eligibility; matching, level of effort, and/or earmarking; special reporting; and special tests and provisions. Paragraph 13(c)(5) of the Attachment to OMB Circular A-133 and its associated Compliance Supplement require that the auditor determine whether those compliance requirements were met. Based on our review of the DCAA audit working papers, we determined that SwRI was in compliance with the specific requirements. That conclusion cannot be made by those reading the report, however, because the requirements were not mentioned.

We have been working with DCAA to correct such audit report deficiencies; therefore, we make no recommendation regarding this finding. The DCAA agreed to train its auditors in the standard audit reporting requirements of OMB Circular A-133.

Material Finding: Inadequate Audit Reporting

The financial statement audit report of SwRI prepared by E&Y for the fiscal year ended September 27, 1996, does not contain a reference to generally accepted government auditing standards (GAGAS). Additionally, the report does not address internal controls or compliance in accordance with GAGAS at the financial statement level.

The Attachment to the April 1990 version of OMB Circular A-133, paragraph 12(a), requires that the audit be conducted in accordance with *Government Auditing Standards*. Paragraph 5.11 of *Government Auditing Standards* requires that financial statement audit reports state that the audit was conducted in accordance with GAGAS. Paragraph 5.15 of *Government Auditing Standards* requires that the audit report on financial statements either describe the scope of the auditors' testing of compliance with laws and regulations and internal controls and present the results of those tests or refer to separate reports containing that information.

The financial statement audit report did not appropriately cover internal controls and compliance because SwRI personnel did not properly coordinate the audit to ensure that either E&Y or DCAA covered each of the required reporting elements. As a result, the engagement letter of agreement between E&Y and SwRI did not identify the required reporting elements.

Recommendation for Corrective Action

We recommend that the Southwest Research Institute obtain from Ernst & Young LLP audit reports on internal controls and compliance that meet *Government Auditing Standards*.

Quality Control Review Objective

The objective of a quality control review is to ensure that the audit was conducted in accordance with applicable standards and meets the auditing requirements of OMB Circular A-133. As the Federal oversight agency for SwRI, we conducted a quality control review of the audit working papers. We focused our review on the following qualitative aspects of the audit: due professional care, planning, supervision, independence, quality control, internal controls, substantive testing, general and specific compliance testing, and the Schedule of Federal Awards.

We reviewed the most recent peer review letter, issued November 13, 1995, by KPMG Peat Marwick LLP for E&Y. The peer review letter stated that E&Y met the

objectives of the quality control review standards established by the American Institute of Certified Public Accountants and that the standards were being complied with during the fiscal year ended June 30, 1995.

Scope and Methodology

We used the 1991 edition of the Uniform Quality Control Guide for Single Audits (the Guide) that was approved by the President's Council on Integrity and Efficiency as guidance for performing the quality control review procedures. The Guide is organized by the general and fieldwork audit standards and the required elements of a single audit. The Guide is further divided into the substantive work performed during the audit of financial statements and during the specific program compliance testing for major programs. Our review was conducted from May 4 through 8, 1998, and covered areas related to the financial statements and major programs.

Results of Prior Quality Control Reviews

Since January 1, 1995, we have performed seven quality control reviews of E&Y. We identified minor quality control review findings and made recommendations at several E&Y locations. We notified the affected offices, and no further action is necessary.

Background

The Inspector General Act of 1978, Public Law 95-452, as amended, prescribes the duties and responsibilities of that office. In implementing those responsibilities, the Inspector General is required to "take appropriate steps to assure that any work performed by non-Federal auditors complies with the standards established by the Comptroller General."

The Single Audit Act of 1984 (Public Law 98-502) was intended to improve the financial management of state and local governments whose total annual expenditures are \$100,000 or more with respect to Federal financial assistance programs; to establish uniform requirements for audits of Federal financial assistance; to promote efficient and effective use of audit resources; and to ensure that Federal departments and agencies rely on and use the audit work done under the Single Audit Act, to the maximum extent practicable.

The Single Audit Act Amendments of 1996, based on 12 years of experience under the 1984 Act, are intended to strengthen the usefulness of single audits by increasing the

audit threshold from \$100,000 to \$300,000 with respect to Federal financial assistance programs before an audit is required; by selecting programs to be audited on the basis of risk assessment rather than the amount of funds involved; and by improving the contents and timeliness of single audits. The Amendments also bring nonprofit organizations, previously covered by similar requirements in the OMB Circular A-133, under the Single Audit Act.

The OMB Circular A-133 establishes the Federal audit and reporting requirements for educational and nonprofit institutions whose Federal awards are or \$100,000 or more. The Circular provides that an audit made in accordance with the Circular shall be in lieu of any financial audit required under individual Federal awards. An agency must rely on the audit to the extent that it provides the information and assurances that an agency needs to implement its overall responsibilities. The coordinated audit approach provides for the independent public accountant, Federal auditor, and other non-Federal auditors to consider each other's work in determining the nature, timing, and extent of their respective audit procedures. The Circular also requires that the cognizant agency obtain or conduct quality control reviews of selected audits made by non-Federal auditors and provide the results, when appropriate, to other interested organizations. The revised Circular was issued on June 30, 1997, to incorporate the changes in the Single Audit Act Amendments of 1996. Its provisions apply to audits of fiscal years beginning after June 30, 1996.

Discussion of Results

During our quality control review, we reviewed and took exception to audit reports on SwRI prepared by E&Y and DCAA. These findings are included in the Immaterial Finding and Material Finding sections of this report. We reviewed and took no exception to the working papers supporting the following reports and schedules prepared by E&Y and DCAA.

E&Y Report of Independent Auditors. The auditor is required to obtain reasonable assurance about whether the financial statements are free of material misstatement. We reviewed the audit program and the testing of evidential matter to determine whether testing was sufficient, based on assessment of control risk, to warrant the conclusion reached and whether the working papers supported the conclusion.

DCAA Report on SwRI Compliance with General Requirements of OMB Circular A-133. The auditor is required to determine whether the recipient has complied with laws and regulations that may have a direct and material effect on any of its major Federal programs. General requirements are those that could have a material effect on the recipient's financial statements, including those prepared for Federal programs. We reviewed the audit program for the appropriate procedures, compared the audit

program steps to those in the Compliance Supplement to make sure that all areas were audited, reviewed the working paper documentation and support, and reviewed the compliance tests performed.

DCAA Report on OMB Circular A-133 Review of Fiscal Year 1996 Internal Controls Used in Administering Research and Development Programs. The auditor is required to assess control risk to determine whether to place reliance on the internal control structure. The auditor must perform tests of controls to evaluate the effectiveness of the design and operation of the policies and procedures in preventing or detecting material noncompliance. The auditor must also review the system for monitoring subrecipients and for obtaining and acting on subrecipient audit reports. We reviewed the audit program for the appropriate procedures, the working paper documentation, and the results of the testing of controls.

DCAA Report on Audit of Incurred Costs for Fiscal Year Ended September 27, 1996. The auditor is required to determine whether the recipient has complied with laws and regulations that may have a direct and material effect on its major Federal programs. Included in this work performed by DCAA was the work related to specific requirements applicable to major programs. Although the requirements are not specifically identified in the report, we confirmed that the auditors performed test work related to types of services allowed or unallowed; eligibility; matching, level of effort, and/or earmarking; special reporting; and special tests and provisions. The Schedule of Federal Awards is also included in the report. We reviewed the audit program for the appropriate procedures, compared the audit program steps to those in the Compliance Supplement to make sure that all areas were audited, reviewed the working paper documentation and its support, and reviewed the compliance tests performed.

Comments

Because this report contains a finding and recommendation, written comments are required by October 13, 1998. If you have questions on this report, please contact Ms. Barbara Smolenyak, at (703) 604-8760 (email: bsmolenyak@DODIG.OSD.MIL). The report distribution is in Enclosure 2.



Donald E. Davis
Deputy Assistant Inspector General
Audit Policy and Oversight

Enclosures

**Southwest Research Institute
Fiscal Year Ended September 27, 1996**

Finding and Questioned Costs

<u>Finding</u> <u>No.</u>	<u>Page*</u> <u>3</u>	<u>Description</u>	<u>Questioned</u> <u>Costs</u>	<u>Resolution</u> <u>Agency</u>
1	3	Leasing Costs for Excess Equipment	\$147,780	NRC

Acronyms

NRC Nuclear Regulatory Commission

*DCAA Report on Audit of Incurred Costs for SwRI (Finding and questioned costs were also included in the DCAA Report on SwRI Compliance with General Requirements of OMB Circular A-133)

Enclosure 1

**Southwest Research Institute
Fiscal Year Ended September 27, 1996**

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Enclosure 2

Evaluation Team Members

This report was prepared by the Financial, Performance, and Single Audits Division,
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